RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Aug. 8, 1990 **LETTER 1049**

July 27 DJIA 2898.51; PTI 3283; A-D Ratio -10.93
Aug. 3 DJIA 2809.65; PTI 3267; A-D Ratio -11.92
Dow Yield: 3.80%; Dow P/E: 13.6; DowPow: 121
Dow Book Value: 1075; Dow 200-day MA: 2742
Percentage of Undervalued Blue-chips: 21%
PTI 89-day Moving Average: 3263

PARTY'S OVER: Slowly but surely people are beginning to revise their opinion of the Reagan years. They now see that the "Reagan prosperity" (and add the Bush "prosperity") were simply credit-induced booms, periods in which Americans ran wild with spending and borrowing. Now it's pay-back time, and as I've been saying for lo these many months, when you party and borrow, party and borrow, you can absolutely count on one condition in your future -- a lowered standard of living.

How's that? Well, if you live in sunny California, here are two newspaper headlines that greeted you on July 27. And both headlines are saying "lowered standard of living" and less services via cuts in almost everything from police protection to garbage collections to medical.

White House Readies $50 Billion Deficit Plan With Tax Hikes

Governor Proposes $2.7 Billion In Taxes, Cuts

By TED APPEL
United Press International

SACRAMENTO — Gov. George Deukmejian and top lawmakers were less than $800 million apart yesterday in reaching a compromise to break the state's record budget impasse, a spokesman for Assembly Speaker Willie Brown said.

Deukmejian gave legislative leaders a list Wednesday of $873 million in tax and fee increases and $1.8 billion in spending reductions, spokespeople for the administration and top lawmakers said.

The governor's proposal left an $821 million gap, which was narrowed during Wednesday's

ed for raising $561 million by conforming California's tax laws with federal laws.

Also on the list were proposals to end the sales tax exemption for newspapers and periodicals for a gain of $40 million a year; increased fees for out-of-state university

The '80s -- they were great party years while they lasted, but these are the "pay-back '90s", and the debts are being called.

Of course, the situation is also tragic. The good old Yankee dollar is sinking to new lows, the US economy is in the doldrums just this side of recession, the bear is coming out of his lair on Wall Street, our brave politicians are frightened of what they may have to do to even begin to cut the deficits, and US corporations are now spending a fat (get this) 28% of their cash flow to service their debts.

NEWS and the TRENDS: Analysts and commentators scrutinize every news-bite, every fuzzy word from Alan Greenspan's lips, every Washington rumor, every squib in the *Wall Street Journal* -- for hints as to the direction of the stock market. I can tell you, however, that they're wasting their time.

Investing in the market on the basis of Mr. Bush's latest pronouncement or the next story out of Congress is the royal road to losses. News events don't make the primary trend, nor do articles from *Business Week* , nor do tips from your favorite TV announcer. The primary trend is the great tidal force of the market and the economy, and it isn't set by the news of the day or the wishes of any man or group of men.

Once a primary bull or bear market starts, it runs to conclusion, regardless of the news of the day, regardless of Washington's wishes, regardless of the machinations of Congress, the Fed or anyone else.

But how do we know the direction of the primary trend? There is a barometer, which, when properly interpreted, can identify the primary direction. That barometer is the stock market, and its function is to discount -- to look ahead. There are many methods of interpreting the trend of the stock market, but there is only one which has withstood the test of time -- and that one is called the Dow Theory.

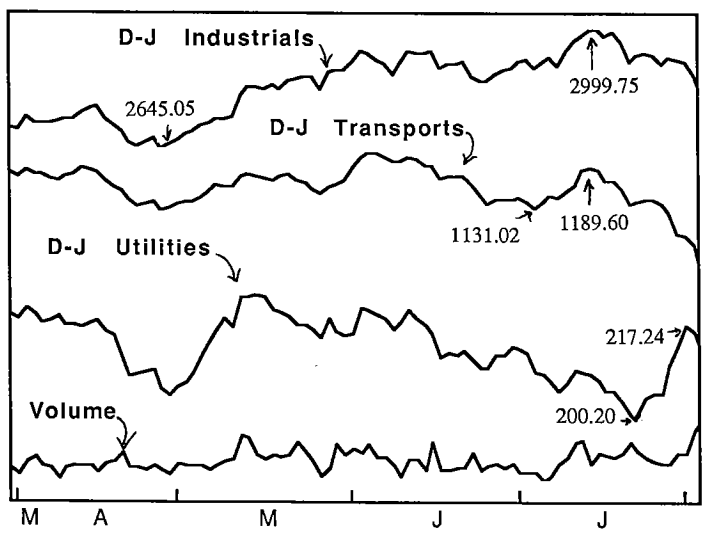
The stock market is subject at all times to three trends, and the three trends are always interacting with each other. There is the minor or daily trend (usually lasting a few days to a few weeks), and this minor trend is often simply a reflection of the news of the day.

Then there is the secondary trend, tending to last a few weeks to many months. The secondary trend often runs counter to the main (primary) trend of the market. In a bull market, the secondary trend can act as a safety valve. For instance, when the market becomes overbought due to frenzied buying by overly eager investors, stocks will correct to the downside. And, of course, the opposite is true in a bear market when sellers become too gloomy and pessimism runs rampant.

Finally, there is the main trend. This is the so-called primary trend, which we term a bull or a bear market. The primary trend may last a year or a few years and even up to a decade or more. Ironically, it is the primary trend that is the most difficult to identify. The reason is that the primary trend is so often disguised by the action of the more obvious secondary or minor trends.

As far as investors are concerned, the primary trend of the market, when it is bullish, is the great fortune-builder. When the primary trend is bearish, it's the great asset-destroyer. **To be invested in harmony with the primary trend is the single most important task of the investor.**

One of the hardest things I've had to learn in this business is to immunize myself from the news of the day. "Ignore the news?" you reply, "Then why read the papers, why watch FNN? Why pay any attention to current events?" The obvious answer is that one

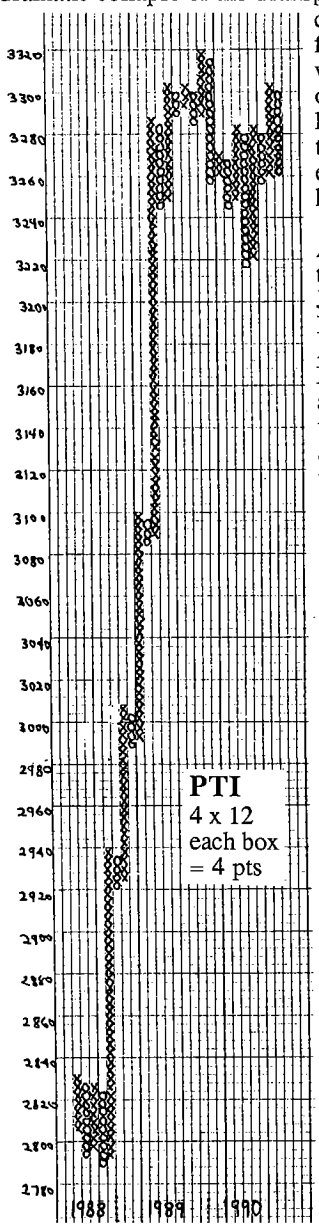


pays attention to the news so one can be an intelligent, informed citizen.

But from the investor's standpoint, the only thing one should be interested in is the market's reaction to the news (rather than the news itself). A market that reacts well to bad news is a bullish market. A market that reacts poorly to good news is a bearish market. Or as the old Wall Street adage puts it, "News goes with the trend."

Back to the primary trend. Since a knowledge of the direction of the primary trend is all-important, it goes without saying that one must learn to identify both the direction of the primary trend and reversals in the primary trend. On this score, it is well to realize that the turns in the primary trend are sometimes dramatic and thoroughly convincing. An example of this would be September-October, 1929. At other times, however, the primary reversals can be subtle, extended and tedious. I believe that we are experiencing the latter situation now.

CURRENT MARKET: The first sign of the current primary downtrend turn came with the shocking crash of October 1987. The second hint came with the lesser crash of October 1989. A third clue to the puzzle occurred when the advance-decline ratio turned down in March of 1987 and continued to lag or decline during all the months that followed. A fourth indication was the dramatic collapse of the Transportation Average in October '89 (a collapse which is continuing). A fifth hint occurred in January 1990, when the D-J Utility Average topped out and (on July 23) broke to a new low for the year. A sixth clue was the dearth of new highs in 1990, even as the Dow rallied to record highs.



Aside from all the hints and signs, the definitive signal occurred on January 25, 1990, when the Industrial and Transportation Averages gave a primary bear signal. Following the bear signal, market action became extremely erratic with the Dow advancing while breadth and the Transportation Average and the Utility Average declined.

Slowly but relentlessly the power of the primary bear trend is beginning to assert itself. As I see it, the stock market has been forming a huge top. It's a top that began to form in 1987, and it's a top that is still in the process of formation. If so, if I'm correct about the enormity of this top, then this still-developing bear market has a long way to go on the downside -- a very long way to go.

There are a few items which particularly bother me at this time, and I want to discuss them. The first is the point & figure chart of my Primary Trend Index (PTI). This chart shows the **PTI** in a massive "stilt" formation, a formation that has not been corrected for years.

Many times as I've studied this chart, I've said to myself, "When this stilt formation finally turns bearish, when it starts correcting all of the upside action of the 1980s, we'll have the nastiest and most persistent bear market you'll ever want to see." Let me put it another way -- I've never seen a market movement up or down that wasn't (eventually) corrected, and I'm sorry to say that this PTI formation will be no exception.

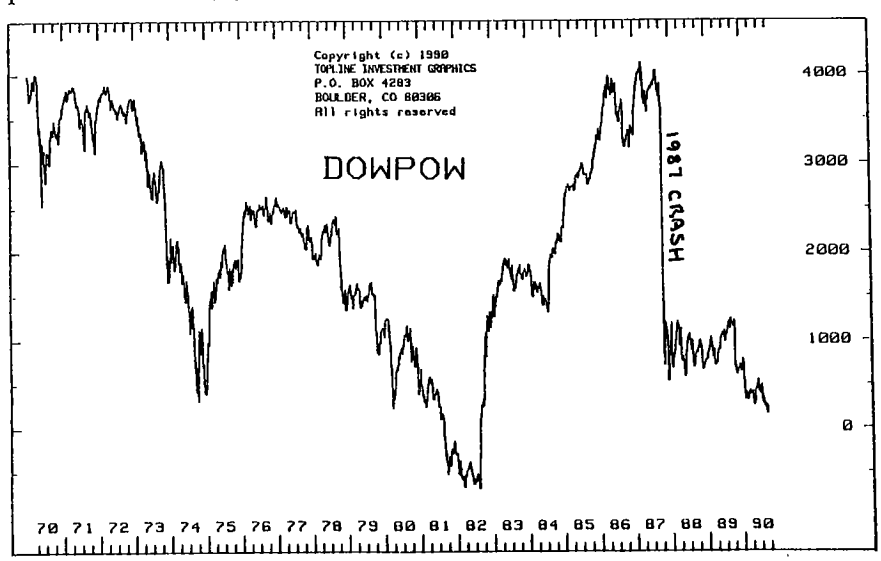
The next item that causes me concern is **DowPow.** This is my proprietary index of the Dow corrected for the action of the advance-decline ratio (chart courtesy of John Carder of *Topline Investment Graphics*). If you looked at the DowPow action -- but only looked at it since the 1987 crash -- you would be convinced that DowPow has a downward bias. Don't believe it. Fortunately I have almost 20 years of daily DowPow history. Note on the chart the great DowPow rise of 1974-76 and again the sensational rises of 1982-84 and 1984-86. These were marvelous money-making advances, fueled by broad increases in market breadth.

Then came the crash of October, 1987 -- and the action changed. The crash seemed to rupture something in the understructure of the market. Following the crash, DowPow moved generally sideways or down. Nothing even remotely resembling the upside action of 1982-84 or 1984-86 was seen.

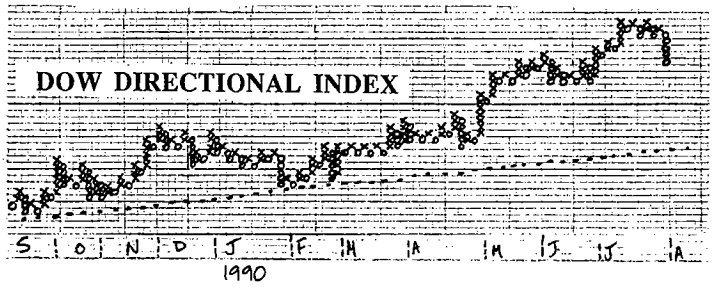
What happened? DowPow is showing us what happened. Market breadth never boomed again as it did during the 1974-76 rise or during the great rises of the '80s. Following the '87 crash, it was pretty much a solo Dow show, and DowPow doesn't move on the action of the Dow alone.

Now here's what I don't like about the picture. If DowPow couldn't move up and away in the face of new record highs in the Dow, what can we expect of DowPow when the Dow itself turns down? My thought is that when the Dow finally turns down, we're going to see DowPow decline in earnest, at which time we will witness a persistent collapse in breadth. Declining breadth is just another way of saying that the average stock will be heading down -- and down.

Today (this is the latest conventional wisdom) analysts are telling us that the 1990s will be "the era of the secondary stocks, the small companies." I'm skeptical. I feel that in refusing to rally, DowPow is warning us that the "little stocks" will take a terrific beating once the Dow turns down. So far, the big (Dow type) stocks have been



helped through their international sales, but most of the little stocks lack this advantage.



The last chart I will show in this series is my Dow directional index. This chart posts an entry each day, but the entry is based simply on whether the Dow moved up or down on each successive day. The rising trend that you see here has been about the most persistent bull trend of any index of which I am aware. The bear will not emerge in full view until this chart drops into a decisive downtrend.

Joe Granville does a piece of research which is a Granville original and a valuable one. Joe (actually it's his good wife) counts all the NYSE issues that are within one point of their 52-week high or 52-week low. Latest count as of July 25 -- 142 stocks within one point of their high and 582 stocks within one point of their low. That, in case you didn't realize it, is a bearish situation.

Comment: So far in this bear market we've had steadily collapsing breadth, a wide-open collapse in the Transportation Average, a new low in the Utility Average and a collapsing dollar. The Dow alone continues to be the strength of the market. How long can the Dow hold out against the force of the primary downtrend? My guess -- not long, and when it does go, the fall should be something to see.

By the way, the current divergence (Dow holding while the Transports and A-D ratio decline) is as spectacular as any I've seen in 40 years of watching markets. Spectacular and extended divergences usually lead to spectacular price movements.

INVESTMENT POSITION: Conventional wisdom has it that if the US sinks into recession, the Fed will lower rates to fight the recession. As rates decline, the US bond market will boom and bond holders will be knee-deep in profits. Sounds simple enough.

But there's a big catch here. This is a global world, and the US depends on the kindness of foreigners to buy our debt or at least to hold what they have. And as the US trade, capital flow and economic condition deteriorate vs. foreign nations (i.e., Germany, Japan, Switzerland, France), the dollar will decline (collapse would be a better description). As the dollar goes down the drain, people (even Americans) will get queasy about holding greenbacks. As they get queasy about holding dollar-denominated items -- and I'm talking about bills and notes and bonds and stocks -- they will sell them.

Thus, I think bonds and stocks will be hit by the weakening dollar. I also think bonds will be hit by rising US inflation (remember, a declining dollar is inflationary in that it means higher costs for goods brought into the US).

Increasingly, I believe that THE investment of the '90s will be the currencies. I have just talked to Citicorp in NYC, and they are now accepting deposits in Deutsche marks, yen and Canadian dollars. In another month, they expect to add British pounds and Swiss francs. Minimum deposits are $50,000 (accounts insured to US$100,000). This, in my opinion, is the wave of the future. Within a year or so, even your local bank may offer foreign currency deposits. And believe me, as time goes by and as Americans see the big picture, the pressure against the dollar will be fierce.

Furthermore, competitive global currency and interest rates will foil efforts to bring US rates down. After all, ask yourself why you should hold dollars when you can hold safer Deutsche marks or British pounds or Canadian dollars at much higher interest rates. By the way, the fat-yielding Canadian dollar is near a ten-year high against the US dollar.

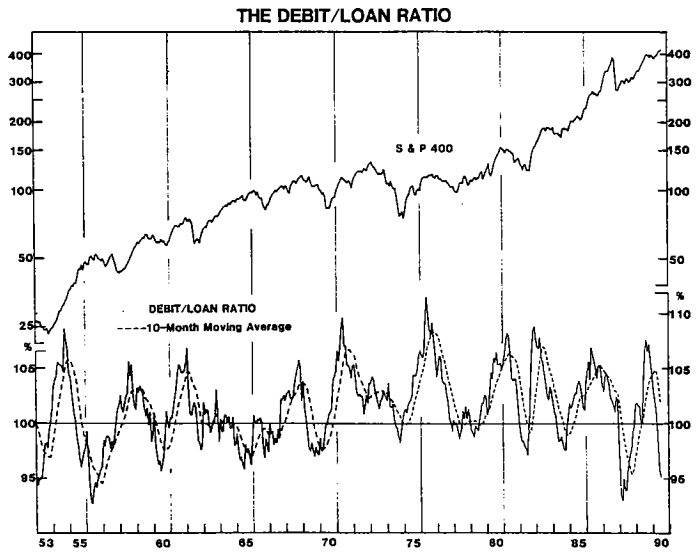
The bear is in the box, and it looks as though he'll be there for quite a while.

DEBIT/LOAN RATIO: The *Bank Credit Analyst* runs a study which they call the debit/loan ratio. This ratio treats the entire US corporate universe as if it were a single stock. The debits equal the money payments in the economy (or business activity). The loans are simply equal to short-term corporate debt.

When business activity (debits) is running high and corporate indebtedness is low, we have a bullish situation, and the D/L ratio will rise. When debt is running high and activity is declining, we have a bearish situation, and at such times the D/L ratio will head down.

What we have now is a plunging debit/loan ratio, and this has always been associated with declining corporate profits, declining corporate liquidity and lower stock prices.

The slumping D/L ratio is currently being reflected in the declining prices of the majority of stocks on all the exchanges. The highly-capitalized Dow-type stocks have, so far, been least affected. But I think it's only a matter of time before they are.

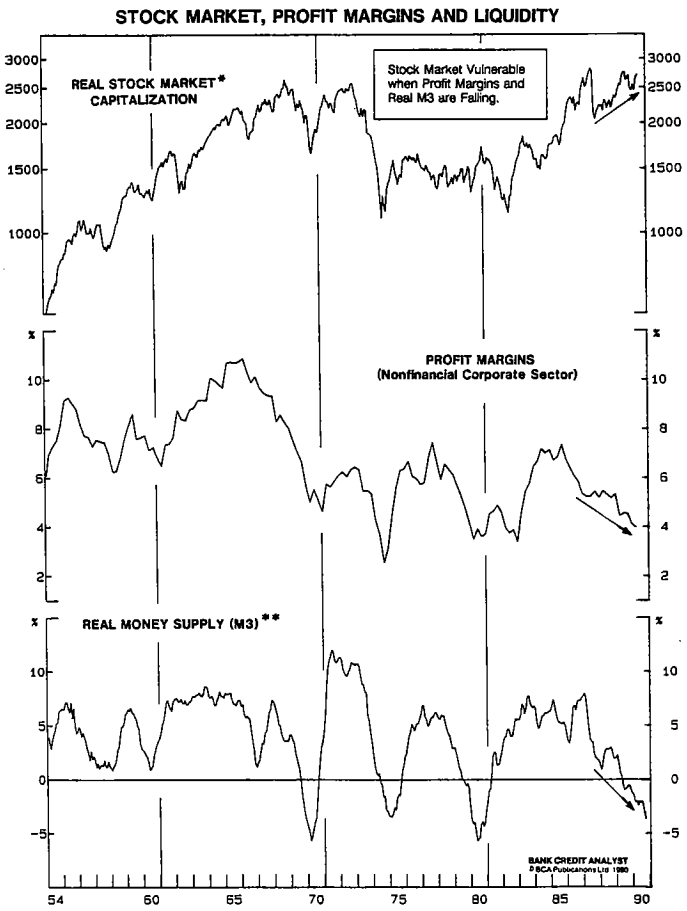


A second very telling chart (see page 4) is included in the current *Bank Credit Analyst*. This is a chart showing stocks, corporate profit margins and the real money supply or M-3. Historically, when corporate profit margins are heading down and at the same time the money supply is contracting, stocks get hit. That's what's happening now -- again, with the exception of certain of the Dow-type stocks [Charts courtesy of the *Bank Credit Analyst,* (514) 398-0655].

OPEN MIND: One of the most difficult things to do in this business is to keep an open mind, which is to say -- to avoid preconceived notions and well-defined scenarios.

Some men have been brilliant about looking into the future. but this too has its dangerous side. William Hamilton, the great Dow Theorist of the 1920s wrote, "The graveyards of Wall Street are filled with the bones of men who were right too soon."

If you are to survive in the investment business, you have to have humility, which means you have to avoid being a guru or a



prophet. This boils down to one procedure -- you must be willing to let the market tell its own story.

One adage which has helped me in this regard is the one which states, "The market always does what it's supposed to -- but never when." Thus, you or I may see the trend of the future as clear as crystal, but we mustn't think that the market has to act on that vision this month or next month or even in six months. Major trends tend to take a long time to develop, and this is particularly true in this age of political intervention and Fed manipulation.

One of the reasons I developed and featured my Primary Trend Index (PTI) was to avoid the trap of egotism, or believing that I knew exactly what was going to happen in the economy and therefore in the market. The PTI tends to keep me honest. This index measures the underlying trend of the market (as evidenced through eight market indices and averages). And no matter what I think might or should happen, the PTI tempers my opinion by showing me what is actually happening.

The recent market experience is a typical example of how this works. Consider this -- the Transports have been falling apart (refusing to confirm the Dow on any and all rallies), the breadth has been dreadful (also never confirming on rallies), the Utilities have looked very poor (not confirming), new highs have been lagging badly, even as the Dow was climbing up to and then above all-time highs, volume has been sub-standard. All these phenomena suggested that this was a weak and dangerous market.

On May 23 (see Letter 1044, page 6), the PTI moved into its bullish mode by rising above its 89-day moving average, and even though I did not like the market action (and still don't), I knew from long experience that a certain amount of pressure had shifted to the upside, and that there would be no real trouble while the PTI was in a rising trend.

In July, however, the undertone action of the market changed. The PTI hit a July 16 peak of 3304, and it has been declining ever since. On August 3, the PTI sank to 3267, exactly on its 89-day moving average. On Monday, August 6, the PTI plunged below its MA, thereby reverting to the bear mode.

NOTES & QUOTES: The US federal deficit for June was $11.2 billion. This compares with June of last year when there was a surplus of $7.8 billion. Not too good, eh? The actual addition to the total federal debt over the last 12 months was **$359 billion!** That's the true size of the deficit -- $6.9 billion a week. Believe it - even though you won't read this anywhere else.

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Since January, 31 states, plus Puerto Rico and Washington, D.C., have raised their taxes. In besieged Massachusetts a tax revolt is underway.

* *

It's weird when you think about it -- the US borrows $1 billion a day and then turns around and gives billions of dollars to over 50 different nations. Another strange item -- those nations voted against the US in the UN 85% of the time.

* *

The *WSJ* (July 24), noting Greenspan's promise of lower interest rates if budget negotiators can come up with "major, substantive, credible cuts," lays out its version of things to come: "So the pieces are falling into place for the following scenario: A cosmetic budget deal, with empty promises on spending. New and awkward taxes. And easier money. The stock market is the town meeting, and it's starting to boo." Russell comment: I'd agree with everything except the easier money. The Fed doesn't control the US money market any more, our global creditors do. And I can't believe that they like what they see.

* *

Here's an interesting quote from my old friend, Harry Browne (*Harry Browne Special Reports,* PO Box 5586, Austin, TX 78763). "In 1948, government at all levels (federal, state, local) commanded 20% of the GNP. By and large city streets were safe -- and children graduated from high school knowing how to read, write, and make use of algebra and knowing quite a bit about the history and geography of the US and the world. The prime interest rate was 1 1/2% (that's not a misprint), inflation was 2%, and a new car cost $1,000 to $1,500.

"In 1990, government commands 37% of the GNP, city streets are battle zones, and children enter college nearly illiterate. Even after a decade of falling interest rates, the prime rate is a lofty 10% -- and despite a decade of deflation, inflation is churning along at 5%. The deterioration wasn't an act of God. It has come directly from the growth in the size and scope of the government."

Russell comment: I agree. But I wouldn't even mind big government if big government was financed out of current income with no debt added. Of course, if that happened people would quickly draw a halt to big government because they would be paying for it directly -- and feeling the pain of what massive government costs. But it's the "big government now and pay later" syndrome that makes me furious. What right does this generation have to saddle my kids' generation with trillions of dollars of debt?

* *

Oh no! When I was a kid my parents used to take me to the fabulous FAO Schwarz toy store in NYC. I'd run around like mad, trying out every toy in the store. I loved that store. Last week, a Dutch company bought FAO out. Back in 1941, I worked a summer at Grossingers Hotel in the Catskills as a busboy ($4 a day if I was lucky). That was one of the toughest summers of my life. Last week Grossingers filed for chapter 7 bankruptcy. What's happening? All my boyhood memories are either being taken over by furriners or going belly up.

* *

According to a very recent *USA Today* poll, Bush's rating had dropped to 50% from a previous high of 68%. And have you noticed the revisions being made for the Reagan years. Now people are referring to the '80s as the "debt decade" or the "party years" and it's first beginning to dawn on the populace that the Reagan years constituted a debt-ballooning binge, while the '90s are already labeled the "pay-back" years for Americans. But that is a misnomer. We'll never pay back the debts that were incurred during the '80s -- never in a million years.

* *

Here's a quote from William Brock, Labor Secretary, and it's worth pondering: "Wages in real terms are lower today than they were in 1973. Business tried to pull wages down and put in labor-saving machinery because so many workers who are coming in from our educational system cannot read and write. The easy answer is to buy the most idiot-proof machinery so business can continue to compete. But today every country in the world can buy the same machinery. If there are people in other parts of the world who will work for $5 a day and they have the same equipment as Americans who want $12 or $15 an hour, either we have to change the way people work here -- not only work harder but smarter, more effectively -- or we have to compete on the basis of wages. The choice is between high skills and low wages. We seem to be continuing to compete on the basis of wages, which means that the effort will constantly be to pull wages down instead of building skills up. We are making the wrong choices." Russell comment: What he's really talking about is a declining American standard of living. It's being built into the US system via illiteracy, debts, global competition, and I might add -- narcotics.

* *

Do you realize that the US is the only nation whose international debts are denominated in its own currency. In other words, US debts are all owed in dollars. Which brings in the temptation to print our way out of debts, both national and international. The catch is that if our creditors perceive that we are doing that, there's going to be a run on dollars, or I should say a run out of dollars. And oh yes, did you notice the Dollar Index dropping to a big new low last week?

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One of the items seriously being discussed by Washington's budget-eers is the elimination of a large portion of the mortgage deduction on housing. Boy, would that hit the middle class (what's left of them).

* *

Ten years ago, 330,000 Americans were in state or federal prisons. Today there are 710,000. Nine out of 10 prisoners are men, but the women's rate is moving up at twice the rate of men (last year 40,000 women were incarcerated).

* *

The California housing market has been the high-flyer of the real estate world, and everyone has been wondering how long it can last. According to what I hear and see and according to the July 26 *LA Times,* things are cooling off in the Golden State. Sales in LA and Orange County are off 20% from a year ago, and prices are being cut -- substantially in some cases. Meanwhile, "affordability" is very low (for instance, in San Diego only 14% of the populace can pass the banks' test for a mortgage on a medium-priced house). In other words, California homes are running out of buyers who can pay the price.

California Real Estate Market Continues to Cool

By TOM FURLONG
TIMES STAFF WRITER

The downturn in the California housing market, which began more than a year ago, appears to be accelerating markedly as prices continued to decline in June and died" in recent weeks, said Joan Wilson, a real estate agent for Grubb & Ellis in Mission Viejo.

The large drop in June is somewhat surprising because it occurred at a time when mortgage rates had stabilized, but the California economy as a whole is

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There's a word for the NY real estate market -- rough. This clip from the July 30 *NY Times* tells the grim story. "I'm seeing the most dramatic surge (in foreclosures) in 25 years," says Roger Sirlin, a Westchester lawyer who represents mortgage lenders in southern NY. "The foreclosures are bridging the entire spectrum. Right now I'm foreclosing on doctors, lawyers, architects, dentists, stock brokers." Says Myron Weinstein, chief of the foreclosure office of the New Jersey Supreme Court, "There's no precedence for the numbers we're getting now. We're getting 1,400 new filings (foreclosures) a month. No one really knows the cause of the magnitude of the jump, except this is the worst real estate market in 50 years."

Home Foreclosures Soar In the New York Region

By ROBERT HANLEY
Special to The New York Times

HACKENSACK, N.J., July 26 — Mortgage foreclosures are soaring in the New York metropolitan region as growing numbers of property owners mist at the Mortgage Bankers Association of America in Washington.

Regional court officials say their figures represent all commercial and

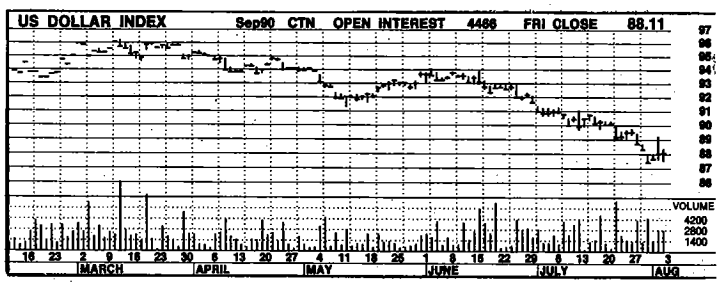
* *

Russia is on the verge of economic collapse. One of the worst aspects of the situation is the food shortage. Not only is Soviet food production inadequate, but 20% to 30% of all food that is produced is spoiled through inefficiency and poor transportation facilities. With it all, the strangest and most depressing part of the picture is the attitude of the peasants themselves. According to Tatyan Zaslavskaya, a leading rural sociologist, 60 years of collectivization have "destroyed the psychological prerequisites for perestroika to succeed." The fact is that the Russian peasants have no desire to work or produce individually. Soviet workers have become used to the habit of working apathetically for the state, and being paid regardless of what they produce. Remember the old Soviet saying, "We pretend to work, and they pretend to pay us." It's happening, and this non-work ethic is, among other things, destroying what's left of the Sovict economy.

* *

In case you've wondered why hotel rooms in London or Paris are $400 and up, glance at this chart of the US Dollar Index, which has dropped sharply over the past year. The question is -- how can the Fed lower rates with the dollar as weak as it is? That's what debt does to you -- it limits your options. Today there's only one way to keep the dollar attractive -- raise rates as Britain and Canada have done.

Pity Mr. Greenspan, on one hand he's watching inflation heat up -- with a further kicker from Saddam Hussein. On the other hand he is watching the country sink into recession. Mr. Bush has been putting the pressure on the Fed for lower rates, but with the new Iraq crisis, Mr. Bush now has his mind on other things. And Alan Greenspan -- I don't think he knows which button to press any more. Gee Alan, a few years ago when you took this job, I'll bet you thought it would be fun (Chart courtesy of *Investor's Daily*).



I've received dozens of letters regarding where and how to place money in foreign currencies. Here's my latest information: The Mark Twain Bank of St. Louis, Missouri, has, for the last three years, been accepting foreign bank deposits. They will take amounts as low as $10,000, and you can place the money in any currency you wish. I prefer Swiss francs and German marks. Current short term rates are roughly 8% for the franc, 7.5% for the mark. Deposits are insured by the FDIC for up to $100,000.

For information on this, speak to Mr. Frank Trotter at the bank, (314) 997-9219.

IRAQ: I purposely left Iraq out of the earlier market discussions for this reason -- from a cold market standpoint, all the Iraqi invasion did was speed up the bear market. With or without the oil crisis, there's a target level down there that this bear market is heading for -- and as far as the Dow Theory's concerned, the only question is how the market gets there and how long it takes to get there.

"News goes with the trend," states the old Wall Street adage. Which is another way of saying that in a bull market everything good or bad, all problems, seem to be resolved happily.

Conversely, in a bear market nothing seems to work out the right way -- nothing.

Today the primary trend is down. Up to now, President Bush seemed to have the good luck angel perched on his shoulder. But my guess is that the good luck angel has flown away. So here's my current appraisal:

(1) With the emergence of the Iraqi fiasco, many of the military cuts in the federal budget are probably out. (2) With oil and gas prices now surging, a new gas tax is probably out. (3) Rising oil and gas prices could not have come at a worse time, at a time when the nation is in recession (or at least close to recession). (4) The Iraqi crisis threatens to run the already horrendous federal budget deficit into the wild blue yonder. (5) With the takeover of Kuwait, Hussein now controls 20% of the world's known oil reserves. If he controlled Saudi Arabia, he would control almost half of the world's oil reserves.

As for Saddam Hussein, the world is now confronted with a power-hungry wildman who has been called "an 800-pound gorilla with a million man army." Hussein has made his move into Kuwait. He cannot turn back or he will lose face in the eyes of both his friends and his enemies. Hussein wants to become the undisputed strong man of the Middle East, the price-setter for world oil, the new Saladin. He is also committed to destroy Israel.

Bush has been pushed against the wall. In uncharacteristic anger (he's usually passive), Bush has taken an irrevocable stand (or should we read his lips again?). Bush wants Iraq out of Kuwait, and he'll accept no puppet government in Kuwait. This may be the prescription for "a military confrontation" commonly known as war.

In retrospect, we now see what so many have warned about. (1) The US is far too dependent on Middle Eastern oil. (2) We note that for years the US has been preparing for a Soviet move into the Middle East. (3) But the US was not prepared for an Arabic internal takeover of the Middle East (Mr. Bush has complained about faulty CIA intelligence). (4) The US is not equipped to fight a land war in the Middle East. Any fighting will have to be basically through the air and from the sea. (5) But it is doubtful whether a war can be won without land power.

Mr. Bush has had a pleasant picnic up to now. His passivity and optimism plus his luck has carried him this far without his having to do anything that required foresight or fortitude. The Bush picnic is over -- Hussein and an US economy on the verge of recession have seen to that.

GOLD: There's something very mysterious about the way IT is creeping up here. Gold didn't explode on the Iraq invasion news as might have been expected -- but it did continue to creep up. Frankly, I like the action. I like the gold action because it isn't doing what everybody expects. "Ah", say the gold haters, "Look, even with major trouble in the Middle East, gold isn't exploding." "Darn", say the gold-philes, "I thought with oil surging over $25 a barrel and the Middle East in an uproar, gold would fly over 400."

I like bull markets that start inauspiciously. I like bull markets that go up slowly with many declines, wipeouts and discouraging glitches. Those are the bull markets that keep Johnny-come-lately's out, and those are the kind that can move pretty far on the upside without anyone really noticing.

My old friend, Bill Tehan of *P.R. Herzig* (71 B'way, NYC, NY 10006), has published an excellent new research paper. In it, he states, "A global liquidity squeeze is developing as monetary reserves contract on a world scale in the wake of weak income and credit and tight liquidity conditions in West Germany, the UK, Canada and Australia. This will bring intense pressure on asset prices and economic activity which in turn will make banks suspect as safe depositories and the so-called 'hard currencies' (D-mark, yen, Swiss franc) suspect as stores of value. In this evolving world deflation, Japan appears to be the counterpart to the US in the 1920s . . . As this global deflation broadens and financial institutions weaken, we look for massive movements of capital into gold as all currencies decline against the yellow metal."

The bull's target for gold is now 380. This is the level of the 65-week moving average. The 65-week moving average is what I call the primary level for gold. Historically, when gold (after an extended drop) rallies back above, and holds above, its 65-week moving average, a new bull market is signaled. On August 6, gold did push above the 380 level (I would have preferred that it did it on its own -- without the benefit of the Iraq news), but let's see if gold can hold above 380 -- then advance from there. If it can -- the gold picture will turn definitively bullish.

LATE MARKET NOTES: Up to now, it's been a strange and exotic bear -- it's been a bear market that never collapses, yet one that everyone loses money in. However, it is obvious that the bear is now coming out of his lair. Last week's and this week's action were a technical nightmare. The Transports fell apart (breaking below 1,000), the advance-decline ratio plunged to a new low for the year, DowPow dropped below even its 1987 crash low (at which time the Dow was 1738.74), and on the single day of August 3, the Big Board produced 244 new 52-week lows. Significantly (and ominously) bank stocks, big, medium and small, have littered the new low list, and the NYSE Financial Index has plunged to a new low for the year.

Perhaps just as destructive, the bond market has been falling apart, resulting in billions of dollars in losses (to both US and foreign holders). On the two days (August 3 and 6), the long Treasury bonds fell four full points. This is one of the things I've been warning about -- bonds set the long-term rates. The Fed may be able to manipulate the short-term rates, but long-term rates are strictly a function of the bond market, and that is one thing no one can control -- it's too big.

The Iraq crisis broke on a Friday, giving the markets the full weekend to digest the situation. I consider it ominous that on Monday (August 6) the markets broke badly again. It's clear that they don't see any quick, painless solution to Iraq, and at this time there's no primary bull trend to mitigate the picture.

The January 1990 low for the Transportation Average was **1031.83**. The January low for the Industrial Average was **2543.24.** Those are two critical levels for this bear market. On August 6, the Transports smashed through the January level. I would expect Industrials to confirm -- in due time.

Mmmm, let's lighten up a bit. Maybe this cartoon will do the trick.

SIR- WE'RE LESS AND LESS IMPORTANT IN EUROPE
WE'RE BEING ECLIPSED ECONOMICALLY BY JAPAN AND GERMANY
AND OUR FOREIGN DEBT IS THE WORLD'S HIGHEST
WORLD'S HIGHEST?
I KNEW IT - WE'RE STILL NUMBER ONE!
BY WASSERMAN FOR THE BOSTON GLOBE

NEXT MAILING: August 22